

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Senate Revenue & Tax Analyst: Colin Stevens Bill Number: SB 1229

Related Bills: _____ Telephone: 845-3036 Introduced Date: 2/26/99

Attorney: Doug Bramhall Sponsor: Franchise Tax Board

SUBJECT: Substandard Housing & Unitary Dividends Technical Changes/Water's Edge Election/Apply Federal Audit Results For CA Purposes/B&CTL Section 25114

SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill, sponsored by the Franchise Tax Board, would make the following changes:

1. clarify that substandard housing could be housing that is either (1) occupied, or (2) unoccupied or abandoned;
2. eliminate obsolete language regarding pending litigation related to the provision allowing elimination from income of certain intercompany dividends;
3. specify that for purposes of determining the correct amount of tax for water's-edge electors, the presumption of correctness attaches to all federal audit determinations, including determinations made at the audit, Appeals, and/or Competent Authority levels.

EFFECTIVE DATE

This bill would be operative January 1, 2000. However, the provision regarding federal audit determinations relating to water's-edge taxpayers specifies that it would be declaratory of existing law.

SPECIFIC FINDINGS

1. Substandard Housing

The PITL and the B&CTL mandate that the Franchise Tax Board (FTB) administer a Substandard Housing Audit Program. The program is intended to assist local authorities in abating housing violations that result in dangerous and unhealthy living conditions. The law applies to taxpayers who derive rental income from substandard housing in this state, including employee housing. This law requires the FTB to disallow interest, depreciation, tax and amortization deductions to any taxpayer deriving rental income from substandard rental property when the taxpayer fails to comply with a notice to remedy the code violation. The funds generated by the denial of any deduction are returned to the local government that initiated the action.

Legislation enacted last year (AB 80, Stats. 1998, Ch. 646) broadened the scope of the substandard housing audit program by providing that, along with taxpayers who derive rental income from substandard housing, the law applies to taxpayers who own a dwelling that is unoccupied or abandoned for at least 90 days and has been cited by a state or local government regulatory agency as constituting a serious violation of state law or local codes.

Board Position:

<u>X</u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> </u> PENDING

Department Director

Date

Gerald Goldberg

4/5/1999

Under the PITL and B&CTL, **this bill** would clarify that substandard housing could be housing that is either (1) occupied, or (2) unoccupied or abandoned.

2. Unitary Businesses/Dividends

The B&CTL requires unitary corporations with activities both within and outside California to combine all business activities when determining business income apportionable to the state for tax purposes. Under the worldwide unitary method, the business income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. The income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales factors.

The B&CTL allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources.

The B&CTL specifies that dividends paid by one member of a unitary group to another member of the unitary group shall be eliminated from the income of the recipient and not taken into account when determining the tax liability of any group member to the extent that the dividends were paid out of income previously taken into account in computing the income of the unitary business.

When the B&CTL section regarding the elimination from income of certain dividends paid between members of a unitary group was first enacted (SB 339, Stats. 1967, Ch. 326), litigation was pending concerning the proper treatment of intercompany dividends. This section was enacted with language specifying that no inference should be drawn by its enactment on the pending litigation. While this section is now 31 years old, and the litigation long concluded, the language regarding the pending litigation has never been eliminated and remains in the statute.

Under the PITL and B&CTL, **this bill** would eliminate the obsolete language regarding the pending litigation on intercompany dividends.

3. Water's Edge Elections

Current Federal Law

Under current **federal law**, corporations organized in the United States (U.S.) are taxed on all their income, regardless of source, and are generally allowed a credit for any taxes paid to a foreign country on their foreign source income.

Federal law uses the "separate accounting method" to determine the amount of a corporation's income subject to tax. The separate accounting method determines the income of related corporations on a corporation-by-corporation basis and does not take into consideration the income of related corporations not subject to tax within the taxing jurisdiction.

The separate accounting method is generally premised upon the use of arm's length pricing in transactions between related parties. Under this principle, the prices or charges on transactions between related parties should be the same as if the transactions occurred between unrelated parties.

However, in many situations related corporations may realize an overall tax benefit for the affiliated group by shifting income between affiliates and not charging an "arm's-length" price.

Internal Revenue Code (IRC) Section 482 was enacted to prevent any arbitrary shifting of income between affiliates. The Internal Revenue Service (IRS) conducts Section 482 audits to determine if the related parties have charged an "arm's-length" price and, if not, what the "correct" price should be. This is commonly referred to as transfer pricing.

Many federal tax audits involving multinational corporations with international issues, particularly those requiring Section 482 pricing adjustments, are resolved at the Appeals and/or "Competent Authority" level. Competent Authority is a well-established process which is incorporated into most tax treaties to assist taxpayers in resolving international double taxation issues by allowing the taxpayer to request negotiations involving the taxpayer and representatives of the foreign government and the IRS. The U.S. "Competent Authority" for these negotiations is the IRS Assistant Commissioner, International.

Current State Law

As an alternative to the worldwide unitary method, **California law** allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources. Therefore, in a water's-edge combined report, the allocation of income between affiliated corporations, some of whom are members of the combined group and some of whom are not, is relevant to the correct determination of income from California sources.

California law requires the department to conduct transfer-pricing audits to ensure that taxpayers include the correct amount of income in the combined report. The department is not required to perform an audit if the IRS is examining the taxpayer for the same year or years on the same issues. If the IRS does conduct a detailed Section 482 audit, California law specifies that it shall be presumed correct and that the results of the federal audit apply for state tax purposes. This presumption can be overcome if either the FTB or the taxpayer demonstrate that:

- An adjustment or the failure to make an adjustment was erroneous.
- The results of such an adjustment would produce a minimal tax change for federal purposes because of correlative or offsetting adjustments or for other reasons.
- Substantially the same federal tax result was obtained under other IRC sections.

If the IRS does not conduct a Section 482 audit of any particular taxpayer, California law specifies that no inference shall be drawn for state purposes from this failure.

The FTB bases assessments for tax deficiencies on final federal audit results, which include audit and Appeals determinations, following long-standing Board of Equalization (BOE) precedent establishing a presumption that federal audit adjustments are correct for all taxpayers. Settlement determinations are incorporated into these final federal audits.

Under the B&CTL, **this bill** would clarify that for purposes of determining the correct amount of tax for water's-edge electors, the presumption of correctness attaches to all federal audit determinations, including determinations made at the audit, Appeals, and/or Competent Authority levels. It also would clarify the federal code sections involved by adding references to Subchapter N of Chapter 1 of Subtitle A of the IRC (entitled "Tax Based on Income From Sources Within or Without the United States"). Finally, this bill would specify that these changes to the water's-edge provisions are declaratory of existing law.

Policy Considerations

This bill would clarify definitions and eliminate obsolete language, aiding in the administration of tax law by making the statute easier to read and comprehend.

The bill would allow the department to utilize competent authority resolutions which are frequently negotiated settlements as a basis for adjusting state returns.

Implementation Considerations

Implementation of this bill would not significantly impact the department.

FISCAL IMPACT

Departmental Costs

This bill is not expected to significantly impact the department's costs.

Tax Revenue Estimate

Provisions of this bill that clarify the law with respect to the definition of substandard housing or remove the pending litigation language would not impact state tax revenues.

The provision that clarifies the department's established audit practice of using federal results and determinations would have no identifiable revenue impact.

BOARD POSITION

Support. At its December 15, 1998, meeting, the Franchise Tax Board voted to sponsor the language contained in this bill.